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# Structuring remuneration to maximise value through 'salary sacrifice'

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**This briefing paper outlines the way in which remuneration can be structured to maximise the return from, among other things, KiwiSaver initiatives without extra cost to employers.**

Recent changes in the tax treatment of superannuation (KiwiSaver and the new PIE regime) mean that employees can make significant improvements to the after-tax value of their remuneration. Whether this is actually good public policy is questionable but there is no doubt about the potential financial gains to employees at the expense, it has to be said, of other taxpayers. We can therefore expect to see a growth in advisory services offered to employers and higher paid employees.

This can get quite complicated, hence the need for advice, so what follows looks just at the highlights. To make the case simple, we assume the employee is paid $150,000 a year; has no current superannuation benefits but has an employer that is prepared to re-arrange things for the employee's benefit on a cost-neutral basis. The employee has also decided to put serious amounts aside for retirement.

There are four possible cases:

(a) the employee does nothing;

(b) the employee 'salary sacrifices' to join just KiwiSaver;

(c) the employee 'salary sacrifices' to join a regular superannuation scheme (and doesn't join KiwiSaver);

(d) the employee maximises the value of salary sacrifice and joins both KiwiSaver and a regular superannuation scheme.

We will look at just case (a) – do nothing – and case (d) – do everything – to illustrate the possibilities. In every case, it is possible for the outcome to be cost neutral to the employer. That is the underpinning basis for what follows.

Under the new KiwiSaver legislation, the employer and employee can agree (after 13 December 2007) to maintain a "total remuneration" approach, including the compulsory employer contributions to KiwiSaver after 1 April 2008. They can be included in remuneration of $150,000 and do not have to be paid on top of pay. Given that the 'compulsory' contributions can be financed out of pay increases that the employer would otherwise have been given, the employer has control of this issue as far as the 'agreement' is concerned. We will assume that our employer has adopted this "total remuneration" approach.

Here is the present position:

| | |
|---|---|
| Gross taxable pay | $150,000 |
| Less tax | $49,770 |
| Less ACC levy | $1,285 |
| Net income | $98,945 |

From the pure viewpoint of tax, the optimal taxable pay that the employee should receive is $60,000 a year. That's because any income above that is taxed at 39% whereas the maximum tax rate on sacrificed pay is 33%.

So, here is the list of things our employee can do, using salary sacrifice to take advantage of the new superannuation environment:

1. 'Sacrifice' $90,000 a year of taxable pay from $150,000 down to $60,000 (plus the "employer tax credit" – see 3. below).

   Some might think that it is better to keep taxable pay as high as possible to maximise the tax-free KiwiSaver contribution by the employer. That isn't the case, as explained below. Maximising the salary sacrifice to a normal superannuation scheme is the first step in this tax-optimal restructuring.

2. Join KiwiSaver and contribute 4% of $60,000 ($2,400 a year from after-tax pay) – this qualifies for the government's "employee tax credit" of $1,042.86[1].

3. Use $2,400 of the $90,000 sacrificed under 1. above to set up the tax-free employer's contribution to KiwiSaver – this also qualifies for a government subsidy – the "employer tax credit" of another $1,042.86 a year.

   The employer tax credit would normally be for the employer to keep as it is the government's way of helping employers to meet the compulsory employers' contributions to KiwiSaver from 1 April 2008. However, this is an employer with a "total remuneration" pay policy where the 'compulsory' contributions will be part of remuneration. In that situation, the employee should benefit from this government subsidy (making total remuneration $151,042.86), rather than let the employer keep it.

4. Have the balance of $87,600 ($90,000 less $2,400) plus the "employer tax credit" of $1,042.86 – total $88,642.86 - contributed by the employer to a registered superannuation scheme. These contributions will attract "specified contribution withholding tax" (SSCWT) of 33%, rather than the 39% that would have been paid on salary. That saves 6% of the amount contributed or $5,319.

5. Reducing taxable pay in this way will also reduce the employee's ACC levy (1.3% of pay to $98,819) – that will come down from $1,285 to $780. However, the pay that counts for income-related benefits will also reduce from $98,819 to $60,000. So ACC income-related disability income cover will also reduce.

[1] After 12 months (if there is a home mortgage), the employee should reduce direct mortgage instalments by $1,200 a year (50% of the employee's own contributions) and arrange a mortgage diversion for the same amount from the KiwiSaver scheme.

The following table shows the new net value of the employee's new remuneration package.

**New remuneration structure**

| | | Net value (p.a.) | |
|---|---|---|---|
| **1. Pay** | $60,000 | | |
| less tax | $14,670 | | |
| less ACC levy | $780 | $44,550 | |
| Less KiwiSaver employee contribution | | $2,400 | |
| Take home pay | | $42,150 | |
| **2. KiwiSaver contributions** | | | |
| Employee | | $2,400 | (from after-tax income, as above) |
| Employer | | $2,400 | (tax free) |
| Plus government subsidy | | $1,043 | ("employee tax credit", tax free) |
| Total to KiwiSaver | | $5,843 | |
| **3. Other superannuation** | | | |
| Before tax | $88,643 | | |
| Less SSCWT | $29,252 | $59,391 | |
| **Total net value of package** | | **$107,384**[2] | |

Note: the KiwiSaver scheme will also receive a net $1,000 "kick start" and an annual membership fee subsidy of a net $40.

So, with a little re-arrangement, our employee has added a net $8,439 a year (8.5%) to the remuneration package ($107,384 less $98,945). That is the equivalent of adding a pre-tax $13,834 a year to pay, at a marginal tax rate of 39%.

If the employee joins the right kind of "other superannuation" scheme, part of the net $59,391 contribution can be used to meet life, disability and medical insurance costs. That will save a net 6% of these costs compared with paying them, as now, from after-tax pay.

Also, the other scheme's money will not be locked up until age 65, as is the case with KiwiSaver. There is the possibility of paying "Fund Withdrawal Tax" on benefits taken early but, with a bit of patience, FWT is a voluntary tax and need not become payable – deferring the receipt of the benefit by two years is one way of avoiding this.

Of course, our employee will now be living on only a net $42,150 a year ($44,550 less the personal KiwiSaver contributions of $2,400) but a net annual amount of $65,234 will now be accumulating in superannuation benefits. That may sound unlikely but, in a two income, older household, one of the incomes could be given over largely to retirement saving. One of the couple can therefore do the retirement saving for both. The "non-saver" should, however, join KiwiSaver.

The new tax treatment for superannuation schemes will confer another advantage on our serious saver. The investment returns under a "portfolio investment entity" (PIE) will be taxed at a lower rate than the saver would have paid had returns been received directly.

[2] Had the employee just joined KiwiSaver (case (b) above), the total net value would have been only $102,236 ($5,158 less). That explains why salary sacrificing to just KiwiSaver is not optimal from a tax viewpoint. However, in the tax optimal case, the employer will have only $42,150 a year to live on.

The "income" in both the superannuation schemes will pay only 30% tax from 1 April 2008 rather than the 39% that the employee would have paid had the income been received directly. As assets build quickly for our employee, that concession will become increasingly valuable.

It is now worth the while of highly paid employees to do some tax planning. Whether that's good for the country is a serious public policy issue. There is, however, no doubt that re-arranging remuneration will be good for the employee's financial health. Is that progress?

**Footnote:** For the really, really serious saver, there is something more that can be done. Salary sacrificing pay from $150,000 down to $38,000 a year (rather than $60,000 as in the example above) has a temporary extra benefit once the employee has completed a full financial year on that lower pay. As long as the superannuation scheme is a "Portfolio Investment Entity" (a PIE), the tax rate that will apply to the investment income earned in the PIE will be only 19.5% (rather than the 30% referred to above). Until the PIE assets are earning more than $22,000 of taxable income, so that taxable pay and PIE income total more than $60,000, the employee will save yet more tax. The PIE assets will probably need to be more than $300,000 before the 30% applies. In the case of a couple, all of these amounts are doubled.

The ACC issue described in item 5 above of the remuneration strategy will see the levy and income-related cover reduce when taxable pay becomes $38,000. However, the employee will lose the tax break on employer contributions to KiwiSaver in respect of the extra $22,000 (the difference between $60,000 and $38,000). It's interesting that that the lower ACC levy (1.3% of the extra $22,000 given up) is almost the same as the tax break forgone (33% of 4% or 1.32%) so there is no real financial loss from the extra salary sacrifice. The employer's ACC levy will also reduce.

**For comments on this briefing and further information please contact:**

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